Question and Answer Period – Morning Session:

Commissioner Kreuger, do you want to start off?

COMMISSIONER KRUEGER: I would like to follow up just a bit, Mr. Chairman, and perhaps address my question to Dr. Schultze.

We talked a lot of course about savings and investment. Obviously the difference is the current account deficit, which to all intents and purposes as everybody has said, is very close to the trade deficit and its magnitude in the U.S. I guess I would like you to spend a minute or two talking about what the current state of thinking is as to the causes of the declining private savings rate in the United States, because that of course is in some sense the key to the whole thing.

As we get to the causes of the trade deficit, if one pinpoints something that looks as if it's changed structurally over time, that's probably it. So it becomes important to examine those determinants.

MR. SCHULTZE: If I had enough time to do the work necessary to answer that question and then lived long enough, I would get a Nobel Prize. Quite frankly, I know one major thing or at least I am fairly convinced of one major thing that has in the past three or four years driven the U.S. private savings rate negative. Presumably it's people being aware of the huge increase in their wealth, paper though it may be, simply find a need to save less.

There is reasonably good economic evidence with murky quantitative measures, that increases in wealth and stock market wealth tend to drive up consumption relative to income. The problem of course is that we don't measure how much very well. But I would suspect that is an important reason.

The one thing that apparently is not driving it in the last 10 or 15 years, are changes in the demographics of the country. There was a period in which people said well, because such a large fraction of the labor force are now baby boomers and that old people tend to dis-save, that the shift in the demographics was driving saving down. That apparently is not the case. So it's not demographics. It is partly the stock market. Beyond that, I'm not sure I have an answer.

COMMISSIONER KRUEGER: Thank you.

MS. MANN: My figure six does show the relationship between the net worth to disposable income rising substantially because of the value of the stock market, close association with the decline in the savings to disposable income, which is one measure of the savings rate. That's in figure six.

It also shows that that decline is not just related to the wealth effect.

CHAIRMAN WEIDENBAUM: Commissioner Hills?

COMMISSIONER HILLS: I would like to ask each of you whether there are measures that you would recommend that our Government take to increase savings in the private sector. And then, if we took those measures, whether you would anticipate that there would be a dampening effect on the robust growth of the overall economy.

I might start with Dr. Schultze.

MR. SCHULTZE: There are two parts to that question. Do I know, have any good ideas about how to raise the private savings rate. The answer is no. I think it's very, very hard to move the U.S. private savings rate. I don't mean you can't do it. Change in the tax structure, for example, needed to do is a very large change for what I believe is a fairly modest effect, number one.

Having said that, the second question is if we could do it, would the decline in consumption relative to income hurt the economy? My answer is no. We do have a Federal Reserve Board. We do have an economy which is sensitive to changes in interest rates. The Fed has shown itself, you can quarrel around the edges, to be very appreciative of the need to maintain high employment. I am convinced that if somehow you could get the savings rate up, you know, unless it all occurred in one quarter, you are not going to see any depressing effect on the U.S. economy, I am morally certain.

COMMISSIONER HILLS: Dr. Rogstad?

MR. ROGSTAD: One of my favorite hobbies over the last decade has been fundamental tax reform. The reason why fundamental tax reform is important, is that it highlights the elimination of the double taxation on the saving uses of income in this country. I think I would differ with Dr. Schultze in terms of the long-term impact of making that structural change in our economy. But I would agree that it would take a while for it to happen.

I think also we need to examine the major reasons that households save. It is primarily for health care, retirement and education. It is important to note that these represent the other major economic issues central to today’s public policy focus.

The real issue at the center of these policy discussions becomes whether it is possible to change the way individuals view their responsibilities for these outlays. If so, there will be increased recognition by households that they will need to increase their saving. Structural tax reform becomes very relevant at this point.

I would expect that over time there would be significant changes in personal saving behavior associated with basic tax and entitlement reform. I do not think the initial responses would lead to significant diminution in the level of overall economic activity, however.

I think that if in fact you have a change in the nature of individual responsibility for the above cited outlays, the recognition on the part of households that they are going to need to save will lead to changes. Structural tax reform can help this process. An unlimited IRA is the way I would do structural tax reform as part of these changes.

Does the recognition of the need to move in that direction by individual households, would that generate the kind of change in behavior that I think would be forthcoming from that. Offsetting an extraordinary early and high impact from such changes, which I would love to believe are there, I don’t think that any adjustment would cause a significant diminution in ongoing economic activity however.

COMMISSIONER HILLS: Dr. Mann?

MS. MANN: I am going to take a slightly different tack. I agree with the notion that fundamental tax reform is necessary, not just to deal with this issue of savings, but also to deal with some other ongoing changes in the way business is done and consumption is done in the economy.

I, for example, think that the issue of electronic commerce and its relationship to the fragmented tax system in the United States is going to become increasingly important. It already is important, at least from the standpoint of legislative activity.

That said, I would like to take, as I say, a slightly different tack on this question and say that the current state of household savings in the United States, its trend decline over time creates a vulnerability of the private sector and for the U.S. economy as a whole, because the private sector is such a large driver of economy activity. If we cannot manage to improve the private savings rate, I think the challenge to other policies, other legislation and financial policies, meaning congressional legislation and the Federal Reserve, the challenges to those policy makers in the next four or five years will be greater than any challenges that they might face if savings rates were to reverse their trend and start to rise.

The vulnerability that I see and the challenges to policy makers that result from the vulnerability, is that debt burdens at the household level and to some extent also in the corporations, within the corporations, those debt burdens will rise, have been rising, and will continue to rise in the event that the economy slows to a more sustainable pace, which I believe it's going to. I don't forecast a recession by any means. But the economy will slow to a more sustainable pace sometime in the next couple of years.

Consumers are spending beyond their personal incomes. They are spending beyond their capital gains. They are achieving a level of spending that is unsustainable. It's very hard to change that level of spending. People get used to having a lot of good stuff and having fun on vacations and eating out, and that level of consumption habit is hard to change. So debt burdens will rise further as the economy slows. That creates a very difficult situation for individuals' personal finances. Their retrenchment ultimately will take place as bankruptcy, Mastercard filings, et cetera, start to change, start to really bite on the household spending habits.

That is a very difficult situation for the U.S. economy, far more difficult, far more potentially -- causing economic disruption, you know, business cycle type of disruption than any disruption that might occur if we were to slowly be able to change people's habits towards a higher savings rate.

CHAIRMAN WEIDENBAUM: Dr. Kregel?

MR. KREGEL: I would like to start out by saying that I really don't believe that we have a problem of deficient savings. I would refer the Commissioners to a study which was produced by Bruce Steinberg, the chief economist at Merrill Lynch earlier this year. He undertook a fairly detailed analysis to include realized capital gains in household disposal incomes.

As you know, realized capital gains are not included in household incomes in the national income accounts. This creates a substantial distortion in our measure of savings rates.

The results that he comes up with are that savings have not changed substantially over the last decade to the last 15 years when these realized capital gains are in fact taken into account.

So on this sort of basis and as I say, these are always estimates because we don't have precise figures on any of this, you have to undertake estimates, on these figures it suggests that the savings behavior of U.S. households has in fact not changed dramatically over the last 10 or 15 years.

The second point that I would like to make is to refer again to one of the charts included in my written presentation, which I did not have time to discuss. This is chart six. And looks at the trade balances for the U.S.'s principal trading partners as a percentage of U.S. GDP.

Now you will note that if you look at the solid vertical line, 1998, this is the limit of current data, all of our principal trading partners have substantial surpluses. These surpluses are in the range of one to two percent. According to forecast predictions on the model of Professor Wynne Godley of the Levy Institute, most of these surpluses are predicted to increase.

Now as Professor Schultze has already reminded us, these are in fact the determinants of what the U.S. savings position is going to be. So if we do undertake measures to increase U.S. domestic savings, then there will have to be some adjustment in the savings behavior of all of our principal trading partners.

So that the second part of the question then becomes crucial. That question is how do we formulate policy decisions which increase U.S. domestic savings, which at the same time, decrease the savings rates of our principal trading partners. So it is not simply a question of what happens to the U.S. growth rate. It is the impact on the rest of the world. This is why it is such a difficult policy question.

If the response of our trading partners were to be, as it was in the 1960s, an attempt to increase their savings rates at the same time we attempted to increase ours, then there would be a very sharp and substantial decrease in global income, and a sharp and substantial decease in U.S. income. So that measures would have to be taken in order to convince the rest of the world to stop being excess savers rather than deficient savers.

This goes back, as I mentioned, to the first part of my remarks, the importance of keeping in mind the fact that any measures that we take to attempt to influence these variables must have compatible policy measures taken by our principal trading partners.

CHAIRMAN WEIDENBAUM: Dr. Schultze, you had a comment?

MR. SCHULTZE: It's just a quibble I guess. But realized capital gains may have some influence on what people say. Actually I think it's really the realized and unrealized together that are most important. But they don't add a nickel to American national wealth in any real sense. From the standpoint of determining the trade deficit, that realized capital gains don't play a part in it. There are simply transfers, somebody pays more for an existing asset than the person who initially bought the asset paid for it. It doesn't add a nickel to the saving investment balance that goes into the trade deficit.

CHAIRMAN WEIDENBAUM: I would like to thank each of the panelists for very professional presentations. Even though they come from a variety of backgrounds, it's fascinating, at least for me, to see in a sense a variation on a common theme. But frankly, I find that quite a contrast to the typical public discussion of the trade deficit, which is more often than not blamed on unfair trade practices on the part of other countries, barriers to our exports, subsidies to their exports, dumping of their products in our markets. How do you all respond to that? Is there anything to it?

Dr. Rogstad, do you want to take a stab at that?

MR. ROGSTAD: I just briefly made a comment, Mr. Chairman, at the end of my remarks on it. I think that this country has spent a great deal of time establishing with our trading partners a set of rules and laws by which the international trading system is governed. When we identify unfair trading practices, et cetera, within that framework, it's important that they be dealt with and taken seriously.

Unfair trade practices are important in their own right, regardless of the existence of any particular trade balance. If there is an unfair trading practice that's having an impact on an American community, industry or business or individual workers, it should be addressed, whether in fact we've got a large trade surplus or a large trade deficit.

Now those unfair trade practices primarily involve particular bilateral and sectoral relations, that can be important for the particular individuals and economic entities that are involved. When you remove a particular barrier, it would certainly bring about adjustments on all of those participants. Those markets would become more efficient, and there would be gains from trade at least over time to all that now can benefit from removal of those trade practices.

But we are talking about aggregate trade data, and trade and investment flows that go into making up the balance of payments of most trading countries, and especially a country the size of the United States. To try to put any cause and effect relating the removal of a particular unfair trade practice and a net impact on the trade deficit of the United States, is equivalent to looking for a needle in a haystack. I don't think this is useful analysis or a preferred mode of attack on unfair trade practices.

CHAIRMAN WEIDENBAUM: Commissioner Becker?

COMMISSIONER BECKER: First let me say I want to compliment the panel for their presentations and tell you I'm not an economist. I represent workers. So I'm not in a position to debating economic theory, but I do want to better understand the economic impact. In that regard, I would like to raise several questions.

One, in regard to the manufacturing or trade deficit that we talk about, I have heard representatives of administrations going all the way back to President Reagan up through the Clinton Administration, indicate that the deficit, is a sign of a healthy economy. Indeed, if that is the case, should we not consider ourselves much healthier today with the news in the papers this morning that the trade deficit has risen to a record $24 billion for this month?

And in that regard, I would like to ask you, at what point does the deficit not become the sign of a healthy economy? Should we be encouraging a higher deficit, looking forward to a $400 billion annual deficit? Should we be shooting for a trillion dollars? At what point does it become a liability rather than an asset and a sign of a healthy economy?

A second question to carry that thought one step further, you mentioned -- there were two separate mentions I think, of the Asian crisis, about which some of us followed with a high degree of skepticism, the IMF's policy of granting assistance to these countries that were on the verge of economic collapse contingent upon their agreeing to austerity programs, and to export their way out of problems.

If what you all are telling me, should we have not had the opposite policy? If those countries were going to regain a healthy and sound economy, shouldn't they be encouraged to run trade deficits? The third question I would like to ask, there has been hints in the paper that the Federal Reserve is going to kick the interest rates up again. I ask if this is a good idea? I am referring back your testimony that individuals are not saving enough money in the U.S. In the case of most of the workers I represent, it's not frivolous spending that is accounting for their lack of savings. In most working families today, both spouses work. And with both of them working, they can't equal what one family supportive job paid back in the mid to late 1970s.

Yet every time the economy seems to be moving to where they can get an increase in wages and share more in the wealth that they are helping create or when the Federal Reserve Chairman believes there’s too many people working, or not enough workers are unemployed, the Federal Reserve raises the interest rates in order to force a higher number of layoffs, and to drive down wages which of course diminishes savings.

So with those three questions, I would appreciate any of your comments.

CHAIRMAN WEIDENBAUM: Dr. Mann?

MS. MANN: Those are all very good questions. They are pretty comprehensive questions. I think you will hear a lot about them in the other briefings that will be put before you. So I think that you probably won’t get all the answers out of us today. So I hope you will stay tuned.

But let me take at least two of them. On the first one, the deficit representing a healthy economy and at what point in time does it not represent a healthy economy. For this question amongst journalists and economists and so forth, the word "unsustainable" becomes a key vocabulary word. At what point does the external deficit become unsustainable.

There are two ways of thinking about that, ways to think about the process by which you get to a point of unsustainable. Although it’s not always a good idea to compare a nation to an individual, sometimes that’s a good way of doing the metaphor. At some point in time, an individual runs up their Mastercard bill, and at some point in time the interest payments on the Mastercard bill are a really large part of their income. Sometimes a very large part of their income. So they can’t both live a normal life and pay off Mastercard. They are at an unsustainable point in both their consumption and their borrowing. They have borrowed too much. That’s one form of unsustainable.

In the context of the U.S. economy, it’s the interest payments on the obligations that we have to foreigners. At what point does that become a very large share of our GDP. My figure one showed that that share, those little dotted bars, was pretty small. It’s $22 billion. That’s not a big number relative to an $8 trillion economy. So that’s not a real good way of thinking about unsustainability. We’re nowhere near that measure of unsustainability.

Another way to think about unsustainability is again, to think about Mastercard, is the Mastercard company says "I’m just not going to let you borrow any more from me," or a bank says "I don’t want to lend you any more money. And you know what? I really think you are in trouble as far as an individual in your consumption habits. I want my money back and I want it back now."

The analogy for the U.S. economy is foreign investors saying to us, "You know, we're just not going to lend you any more. We don't really want to buy your assets any more. We don't want to invest in your country any more, and your companies' individuals and so forth. You know, we may actually like to take some of our investment portfolio away from you in the United States and put it back into our own countries or into some other country." That is also a measure of unsustainability.

At that point in time, the value of the dollar -- there would be a variety of things that would happen, but the value of the dollar would be one indicator of the deterioration in foreigners' willingness to invest in the United States.

My view on the unsustainability question is that we're not in an unsustainable situation right now. Based on U.S. experience over time and other countries' experiences with these types of situations, we are a number of years away. But we are on a trajectory that is unsustainable. We're on a trajectory that's unsustainable, and at some point in time, about two years according to my very rough kind of calculations, the rest of the world is going to start to say we're not so happy about lending to you any more.

COMMISSIONER KRUEGER: Mr. Chairman, may I just follow up on this for one second with a follow-up question?

CHAIRMAN WEIDENBAUM: Commissioner Kreuger?

COMMISSIONER KRUEGER: Would you distinguish between borrowing for consumption and borrowing for investment in terms of sustainability?

MS. MANN: Yes. I do make that distinction between borrowing for consumption and borrowing for investment. I also make a distinction between borrowing through short-term fixed contractual arrangements like banks versus borrowing by say having equity, foreigners buy U.S. stock market. The dynamics of adjustment would be very, very different through short-term contractually based liabilities as compared to equity type liabilities. It is true for the United States that the obligations now have been much more equity-based. They have been used for investment, less for consumption, as compared to previous times. That’s why I don’t view our current situation as being unsustainable.

But the trajectory which is based on the private savings rate, is unsustainable. The same type of vulnerability that individuals have, is a vulnerability that the United States has. There’s plenty of time to change behavior. So in that sense, I emphasize the trajectory is unsustainable, not that the situation we are in right now is unsustainable.

CHAIRMAN WEIDENBAUM: Thank you. Commissioner Zoellick.

COMMISSIONER BECKER: Mr. Chairman? Could I follow one point on that same question though? The trajectory appears to be from at least over the last couple of months, a $4 billion increase per month. How do you feel about that trajectory?

MS. MANN: That's the trajectory I have been working with. As I say, that is a trajectory that's unsustainable, but it is not -- there is no crisis.

COMMISSIONER BECKER: But the trajectory is unsustainable, that $4 billion increase per month?

MS. MANN: Four billion dollars per month is not really a big number in the $8 trillion economy.

CHAIRMAN WEIDENBAUM: Dr. Schultze?

MR. SCHULTZE: I am not sure I have a strong opinion on the extent to which the trajectory is unsustainable or not or over how long. But I think that is what's really critical is it likely to end with a bang or a whimper. That is in some cases Korea, Thailand, Indonesia, it was a bang. There was a liquidity crisis. Foreigners literally got out. They pulled their capital out.

That is not going to happen to the United States. More likely to happen, however, is to the extent this is unsustainable, it will lead to a depreciation of the dollar. The dollar will begin to lose value. That will begin to correct the trade deficit. But conversely, it will give us inflationary problems at home and reduce our standard of living.

So I agree. The sustainability is an important question, but I don't think it's so much a question of some great big catastrophe facing us if we don't do something about this. It will probably take care of itself in ways we won't like, but won't be catastrophic to us.

While I'm doing this, let me make one other point. I think Mr. Becker, I thought seemed to indicate that pretty much everybody has been saying the deficit is a good thing. I don't believe that. I just believe it's a thing. I don't think you can say whether it's good or bad until you say what is driving it, and do you like the things that are driving it.

COMMISSIONER BECKER: The word I used was healthy, a healthy economy. That's what I have read.

MR. SCHULTZE: Well, I don't think the deficit, to cut through an awful lot of potential footnotes, I don't think the deficit itself makes us healthy or unhealthy. I would much rather have an economy, given my preferences, in which we did more saving and didn't have to borrow so much abroad and didn't have to run such big trade deficits. So in that sense, it's a symptom of something unhealthy.

The other side of that is, is give me the fact that saving, low saving in the United States is here to stay for a while, then I would rather borrow from abroad than have to do what's necessary to cut back domestic investment.

So I think it's very hard to say whether it's good or bad. I certainly wouldn't want to join any chorus which said it's a healthy thing.

CHAIRMAN WEIDENBAUM: Dr. Kregel?

MR. KREGEL: Again, I will represent the international perspective, and suggest that yes in fact this is something which is preoccupying. Preoccupying because if we look at comparative growth rates, the United States cannot grow at four percent on average over time and the global economy grow at two percent, which means that most of our trading partners are growing at substantially less than two percent. If those conditions were to prevail, then in fact the deficit would be on a trajectory which would be extremely preoccupying.

Now having said that, we have to be very careful in assessing the statistics according to which we finance the deficit. We have just had a revision of factor income flows in our national statistics which have changed by a period of two years the point at which the inflows relative to the outflows have turned negative.

Now there are a number of factors which influence this particular statistic, relative rates of return on foreigners' investments in the United States, relative rates of return on our investments abroad, as well as exchange rates. So changes in exchange rates and relative rates of return can very rapidly change the recorded financing deficit. So the sustainability question again comes up. If there are sharp adjustments in any of these variables, we can find the figures moving from positive to negative very quickly.

Were it to be the case that we ran a very large deficit and the rest of the world decided to dollarize, then effectively we could finance this at zero cost, because they could simply holding our currency and we would not have interest rates to pay at all. This would be an extreme case.

So having said that yes, it would be preoccupying if these growth rates remained at the present rate, it also depends on the rate at which we finance the borrowing which we use to cover the deficit.

I would also like to briefly comment on the response to the Asian crisis. If you will recall, in part of my presentation I noted the difference between the behavior of values and volumes in imports and exports. Now the presumption of the austerity programs was that most of the Asian countries, having substantial foreign currency indebtedness, would have to repay this indebtedness, and they would have to do this by selling more exports. That is, the value of their exports relative to the value of their imports would have to become positive so that they could effectively earn dollars in order to pay back the U.S. institutions that had lent them money.

Now unfortunately, there was a secondary factor which entered into the equation. This secondary factor I suggested was the terms of trade. That is, the change in the prices of the major Asian exports relative to the price of U.S. exports. So that what effectively happened was that for most Asian economies, their trade balances improved, but they improved because their imports contracted by substantially more than their exports. In the early period of adjustment most Asian economies had declines in their exports, but imports declined relative to exports, so that the entire economy was shrinking. This is how they were increasing their U.S. dollar balances.

Now this obviously has a sharply negative impact on growth, because it says that the Asian economies are earning dollars to pay us back, but they are doing it not by buying more of our exports, but by buying less. So the response should have been -- and as I say, this is why the terms of trade impact was important. The terms of trade impact brought about a sharp decline in the incomes of these countries, which simply added to the austerity programs which were being recommended by the IMF because they believed that the devaluations would be inflationary. In fact, these economies were in such sharp deflation, that there was very little impact on prices. So that you had a double factor pushing down their rates of expansion, and therefore, pushing down their ability to buy U.S. exports. This is why, if you look in 1997, the value and the volume figures of U.S. exports turned sharply downwards.

Now the response to this would have been what? Well, we wanted the adjustment. We wanted them to have a surplus on their balance of payments. That should have been reflected in a deficit in the U.S. balance of payments. But it should have occurred by means of an expansion in both their exports and their imports. Had that been done, then U.S. exports would not have had to decline, and we would not have had that negative impact then on the U.S. economy.

So it's a question, is the deficit good or bad: the deficit good or bad if growth rates are positive or are growth rates declining? If it is in an environment of declining growth rates, then clearly it is a negative factor. This is what was happening throughout the Asian recovery.

In fact, the Asian recovery was brought about by a decline, a decrease in overall global growth rates rather than a stable increase.

CHAIRMAN WEIDENBAUM: Thank you, Dr. Kregel.

Commissioner Zoellick?

COMMISSIONER ZOELLICK: Thank you, Mr. Chairman. First I would like to thank all four of you for taking your time to be with us today. It was very helpful.

I have three questions. I would like to put them on the table so you at least have some time to think about them. The first one is for Dr. Mann. Dr. Mann, when you talked about the causes of the trade deficit, you referred to Dr. Schultze's comments about savings versus consumption and investment. You also referred to Dr. Kregel's reference to relative growth. You put in exchange rates as well, obviously.

My question is, what would be the relative weights of these influences, and if they vary, why do they vary over time?

The question for whomever would like, is that I have been hearing now for about 30 years from economists that trade flows reflect capital flows. I understand the accounting reason why this must be so. But why do you put capital flows first? Why don't you say the capital flows reflect trade flows?

Third, since there seems to be some general agreement on this panel, I would like to try to pull out what I assessed was perhaps a difference between Dr. Kregel and Dr. Schultze. This is on the issue of savings. I realize that economists have a responsibility for maintaining their reputation with the dismal science, but why don't you count wealth increases in savings?

If I am an investment manager, I mark to market. I count increases to my wealth or I count my losses. If I am a corporate executive and I have an increase in value of my company's shares, I actually can buy things with those shares. I can buy other companies with those shares, which is one reason why we have had a lot of M&A activity.

So why don't economists want to count the wealth increase? I understand that it's volatile and may be difficult to measure. But I also understand that economists refer to the wealth increase all the time. They refer to its effect on consumption. Dr. Schultze referred to its possible effect on savings. So why doesn't the theory factor it in?

Dr. Mann, perhaps you could do the first one.

MS. MANN: Okay. You had asked about the relative weights of influence of these three factors affecting external balance. One being the internal savings and investment imbalance. One being income differentials. One being the exchange rate. They are all -- they are sort of shall we say three sides of the same coin.

There are two different ways of examining the underlying pressures for a trade deficit. I distinguished between the income and exchange rate way of explaining the trade deficit from the savings and investment or internal balance way of explaining the deficit, principally because those are two camps that are well-defined in the profession for thinking about these things.

What I try to suggest is that there is a very close relationship between these different ways of looking at the deficit. For example, one clear relationship is in the last six or seven years, during this expansion, the interest rates have been low. That has encouraged an expansion in business investment, in technology-based investment in particular, information technology. That has led to expansions in corporate profits, increased productivity growth, and increases in stock market values. So we have an increase in investment and an increase in consumption, reduction in savings.

How does that play out in the income and exchange rate way of thinking about the external balance? Well, the low interest rates have increased real investment, real investment activity, which has powered U.S. GDP growth. That has increased the income differential that's driving the trade deficit. The reduction in savings rates increasing individuals' consumption has increased imports more because U.S. consumers buy a lot of imports. They like the diversified set of things to buy, not just U.S. bought, U.S. made, but other things. And of course U.S. corporations have distributed worldwide their production structure. So that also increases imports.

Finally, the attractiveness of the U.S. investment climate of high and rising equity markets, very robust corporate activity has tended to make the U.S. an attractive place for foreigners to place their portfolio of financial investments.

That has tended to raise the value of the dollar above what it might otherwise have been. That tends to change relative prices in the direction to further augment imports and tend slightly to depress exports and widen the trade deficit more.

So you can see the linkage between the savings and investment way of describing the trade deficit, how that plays out in the income and exchange rate way of looking at the trade deficit. Capital flows are a key component of that linkage.

COMMISSIONER ZOELLICK: Thank you. Any takers on the other two questions, which were again why we put the capital flows ahead of the trade flows, and then the wealth effect issue.

CHAIRMAN WEIDENBAUM: Dr. Schultze?

MR. SCHULTZE: The wealth effect, lately this is a debate I have been having at least once a month. There are two aspects of national wealth. There are two ways of wealth to look at it. If I am trying to decide what's driving consumers to do what they are doing by way of their savings, then indeed I do want to take account of what's been happening to the market value of what they call their wealth because it helps determine how much they spend. Therefore, it's very important.

On the other hand, if I want to evaluate the share of our national income that we're devoting to the production and purchase of productive assets, which is the definition of saving that is used in the national income accounts and which is used when you want to look at how fast a nation might grow, then the increase in the price of an existing asset is irrelevant. Very relevant to me as a consumer in determining what I want to do, do I want to take an extra vacation this year.

For example, when Japanese real estate prices soared, if you actually did the numbers, Japan was about four times wealthier than the United States, which of course is nonsense, as they and us now know. If the number of taxi cabs in New York are shrunk and cab medallion prices go way up, is that an increase in the city's wealth? No. Therefore, you need to distinguish those two purposes for which you are trying to get wealth data. Real wealth is what you put aside each year from your production to invest in productive assets, R&D, plant and equipment. That does not include capital gains. Whereas --

COMMISSIONER ZOELLICK: If I could just follow up on this. If my shares in Daimler-Benz increase and I go buy Chrysler through an exchange of shares, I now have acquired some assets that have earning power. I could actually, if I wanted to, take them back to Germany. So please explain to me why that wealth effect doesn't increase overall national wealth.

MR. SCHULTZE: If the economy was in deep recession, and if you hadn't bought that Chrysler, somebody would have been unemployed and there would have been less output in the country. We could then argue about how you want to deal with it. But in an economy running reasonably close to full employment, the fact that you bought the Chrysler doesn't add to national production at all. Again, I'm talking about it from national standpoint of do you or do you not increase the goods and services that have been turned into productive assets.

COMMISSIONER ZOELLICK: I was referring to buying Chrysler as a company, not a car.

Dr. Kregel?

MR. KREGEL: Perhaps it's useful to go back and look at the history of national income accounting, which comes from a very famous U.S. economist, Irving Fisher. The idea behind calculating national income is to ask the question, just exactly how much could we eat up out of what we've got and be able to continue to eat that amount every year thereafter. Okay? So that the concept behind income is to keep the productive structure roughly constant.

Now, Fisher's argument was that if we changed the price at which we value that productive structure, it really doesn’t change the amount of real goods and services that the productive structure can produce in the future. So Fisher’s answer was obviously that changes in the prices or the capital values of that productive structure should not be included in real income. It was as simple as that. That was the basis upon which we founded national income accounting and the concept of real income. Okay?

So if you follow that logic, by definition, capital gains should not be included in income. If they are not included in income, they can’t be included in savings. If they can’t be included in savings, obviously they can’t be included in accumulated real savings, which represents wealth. So this is one particular way of looking at the way we do our calculation of what we mean by real income.

On the other hand, there is an alternative which says that real incomes, real values really are relatively meaningless. What is meaningful is the rate at which we can convert those real things into money. Our ability to spend is determined by the rates at which we can convert them into money.

So that if you can buy your Chrysler shares at one value and they appreciate by 200 percent, and they have appreciated by 200 percent relative to Daimler-Benz shares, and you then take over Daimler-Benz Corporation, you have in a very real sense increased your real wealth position.

So it is simply a question of how you choose to do that particular sets of accounts. By tradition, we have chosen to calculate real incomes in this particular way.

There is a school of thought which suggests that this is extremely misleading and would adopt yours. But it's simply a question at this point in time of convention.

COMMISSIONER ZOELLICK: If I could just ask the Chairman's indulgence. The connection that I am then seeking here is, is that since at least some or perhaps all of you referenced the importance of savings to the question of the trade deficit, I am trying to figure out if one looks at the alternative framework that you outlined, not the national income account framework which all this has been based on, but one that calculates some aspect of wealth effect, how might that lead us to think any differently about the current account deficit?

You made a comment in your opening statement that went in this direction. I am trying to probe the others. That if I move them a little bit out of the standard framework that I've had for 30 years and take into account market valuations, which I certainly do in the marketplace, how does it affect how we think about this issue?

CHAIRMAN WEIDENBAUM: Dr. Mann?

MS. MANN: The way that I think that we ought to think about this is again, a cycle versus trend. The way you put your question was a little bit like wealth and savings, and they are not the same. I think it is important to distinguish between the two of them in terms of how they affect consumption and debt burdens of individuals.

If you look at the behavior of savings through non-equity based vehicles. So if we strip out the capital gains component and we just consider savings in contractual obligations, deposits, and even let’s say throw in consumer durables, which some people do. There’s a very good paper by Bill Gale and John Sabelhaus coming out from the Brookings Institution (which, Dr. Schultze, I’m surprised you didn’t advertise that one). Anyway, that paper builds up several different measures of savings, including this capital gains component. Indeed, if you include the capital gains component, savings is very high.

The point is, it’s also very volatile. If you are a consumer, if you are an individual and you get to a consumption level based on an unsustainable foundation of that consumption, meaning your personal income, plus your capital gains, then when those capital gains erode, when the stock market doesn't rise at the rate that it has been, your consumption pattern stays at the same level. Basically I'm saying consumers don't immediately respond to changes in their underlying capacity to spend. So they will continue to spend at that higher rate. They will borrow to do so. That creates a vulnerability that is different than a consumption level that is based on a more stable foundation, not based on capital gains.

So that is the way I think that you can link the capital gains approach to understanding savings from wealth and this would be true as well in your mark to market.

COMMISSIONER ZOELLICK: So your assumption, and I don't mean to me normative about this, is that you are assuming consumers are irrational in that they do not understand that markets go up and down.

MS. MANN: Yes. Consumption habits change slowly.

COMMISSIONER ZOELLICK: And that their sense of consumption patterns are based on a rather optimistic view of their increase of wealth. I don't know what that assumption does, by the way, with the permanent income hypothesis according to which people do make these adjustments in consumption over their lifetimes. Therefore, you are worried that people are consuming too much because times are too good. So therefore, you want to adjust the system to counter that.

MS. MANN: That is accurate, yes.

CHAIRMAN WEIDENBAUM: Commissioner Lewis?

COMMISSIONER LEWIS: Dr. Schultze, you said in opening your remarks, and I appreciate what everybody has said and the time you are taking to help us. You said in your opening remarks that trade policies don't affect trade balances. I would like to ask you from the point of view of other countries, from the point of view of Japan or Korea or Indonesia or China, do their trade policies affect trade balances?

MR. SCHULTZE: In my five minutes, I stuck the word in the long-run in as a qualifier on my point that they don't affect it. In the short run, changes in trade policies, if they are large, presumably can affect the trade balance. But I think, I'm sure they will set in motion other changes in both sides of both economies that will tend in the direction of restoring the old situation. That is, that trade policies can enormously over long periods of time, influence the level of both exports and imports. Trade liberalization in the world over the past 40 years has had a massive effect in increasing exports and imports everywhere.

In the short-run, if a country tries, for example, to get a "advantage" by altering its trade practices in say a very protectionist on the one hand, or a very subsidized export economy, yes, it can improve its trade balance for a while. But that is going to set in motion changes in exchange rates and interest rates and other things that will restore it.

COMMISSIONER LEWIS: Okay. The follow-up question to that would be then there are countries whose trade balances have grown substantially from 1945 to now. They didn't have the surpluses then that they have now. They have been on a sustained trade surplus curve.

MR. SCHULTZE: Japan.

COMMISSIONER LEWIS: Well, more than Japan.

MR. SCHULTZE: Yes, but it's a big one.

COMMISSIONER LEWIS: China is on that trajectory right now, and Korea was for a long time. Indonesia. Why haven't the forces that you're talking about come into be so that they go back to the trade balance that they had? Because it seems to me there has been a fundamental shift in their trade patterns.

MR. SCHULTZE: In the case of the Japanese, for many years now -- I don't mean for the whole post-war period, but for -- I'm not enough a historian of this to know the exact timing, but for the last two-and-a-half decades, certainly, they have on the one hand saved substantially more than they had profitable opportunities to invest at home. In turn, that has generated a persistent trade surplus.

COMMISSIONER LEWIS: Even when their growth rate was greater than the rest of the world, they were still having surpluses.

MR. SCHULTZE: Yes. Yes. Because they still had this massive excess of saving over what they could invest at home, which tended to drive down their interest rates, make it profitable for the Japanese to invest abroad. They didn't always make good choices, but -- and that's persisted for year after year. I suspect it was probably true that that saving investment in balance and the trade surplus wasn't something that started in the 1940s. But it has surely been with us for 20 years now.

COMMISSIONER LEWIS: Why haven't the adjustment forces caused their surplus --

MR. SCHULTZE: The adjustment -- there are no adjustment forces if you insist on saving more than you can invest at home.

COMMISSIONER LEWIS: But the yen should have appreciated in value, which according to the theory that you went through before, the yen should have appreciated in value. Their exports should have been more expensive. Their imports should have been less.

MR. SCHULTZE: No, no, no. I didn't say that. I said if they change their trade practices, and didn't change their saving and investment, that would happen. But once you -- if your investment and saving is kind of persistently at a given relationship, then your trade balance will tend to stay where it is. Again, subject to fluctuations from year to year because of cyclical developments.

COMMISSIONER LEWIS: Would the other countries that have been growing trade surpluses also not be the result of their trade policies?

MR. SCHULTZE: Yes. Again, taken over any length of time, that's right.

COMMISSIONER LEWIS: And then I have one question for Dr. Rogstad. On page three, could you please explain the last three lines?

MR. ROGSTAD: On the relative position of business cycles, in the U.S. being a closed economy?

COMMISSIONER LEWIS: The last three lines, yes.

COMMISSIONER THUROW: The puzzle is why you have called the U.S. a closed economy.

MR. ROGSTAD: I find it interesting. I think there is a paradox here because exports (or imports) to GDP today are roughly one-seventh, but growing rapidly, however. You look at the dynamics of these forces that we're talking about. I bring this up in the context of the nature of the adjustments that are going on in the U.S. accounts, aggregate exports, imports, our investment and savings flows.

Specifically, roughly 85 to 90 percent of those adjustments are determined by factors, internal to the U.S. economy. Yet I think that the importance of international trade flows to American households, American businesses today is extraordinary. It's determining the tone, it's determining the cutting edge of most business activities that I know of, and indeed, more and more households are also impacted.

I only make the observation about the U.S. being a relatively closed economy because the notion of how rapidly particular changes in those trade accounts, that we might attribute to changes in the balance of trade, are able to work their way through the U.S. economy. You need to keep it in perspective.

We are a huge dynamic economy. Trade is very important, but it's only a piece. It's that sense that I was putting in play here.

CHAIRMAN WEIDENBAUM: I am not sure if I'll be helpful, but I wonder to what extent this is a language problem.

Dr. Rogstad, when you say "closed economy", that conjures up notions of trade barriers.

MR. ROGSTAD: Oh, I'm sorry.

CHAIRMAN WEIDENBAUM: I don't want to put words in your mouth, do you mean that the economy of the U.S. is more oriented to the domestic markets?

MR. ROGSTAD: Yes. I was talking about shares of total U.S. activity that reflect international versus domestic activities. One of the great things about the United States is that in fact it is a leader, in arguing for open trade and investment flows. So if that's the interpretation, I apologize. Poor language.

CHAIRMAN WEIDENBAUM: Thank you.

Commissioner Papadimitriou?

VICE CHAIRMAN PAPADIMITRIOU: Thank you, Mr. Chairman. I too want to welcome you and also thank you for taking the time to be with us today. Your comments are extremely valuable.

I want to take us actually to a different question, which I have not heard. That is, whether you believe that the causes of the trade deficit have anything to do with institutional structure, number one or two, in terms of competition. Does competition have anything to do with the trade deficit? Does the institutional structure, whether you will take these institutions in terms of governmental regulation, industrial policy, or whatever -- I will leave it up to you in terms of defining the institutions that perhaps might play a role in causing the trade deficit.

MR. SCHULTZE: Let me throw out a comment, not an answer. I would have to think about it. I haven't thought about it in those terms.

The one thing that has been missing from all our discussion, understandably because of the question we're asked, is the very important impact of trade policies and the like on the distribution of our exports and imports, the distribution of employment. All sorts of distributional questions. Even though I don't believe that those policies have a lot of affect on the aggregate trade deficit, they are terribly important in terms of the composition of all of this.

In turn, U.S. policies with respect to regulation, with respect to competition, I would have to think about what I believe they do to the trade deficit itself, but I would say they have very important implications for the kind of trade we carry on. You know, we're not exporting apparel very much, but we are sure as heck exporting an awful lot of high tech, electronic stuff. Different regulatory and competitive policies affecting how our industries develop could have a major impact on what we end up importing and exporting, and in turn, on our living standards. What do we get for what we sell. So I think it's terribly important, but I'm not quite so sure what it does to the trade deficit.

CHAIRMAN WEIDENBAUM: Dr. Mann?

MS. MANN: Two sort of tacks on this question, which is pretty broad. One is that a very large share of our trade, both the outgoing and the incoming, is related to each other in the sense that an increasingly important role for trade is to represent parts of a production process as opposed to sort of in the olden days when we learned trade originally, you know, you imported the raw material that you didn't have at home, and then you exported something to another country that they didn't have. So it was very different. Trade was based on endowments and different kinds of resources. It was mostly related to either a resource or a finished product. You know, that was kind of our original model of international trade.

Well basically, the U.S. doesn't do that. Most of the other industrial countries don't do it either. Increasingly, nobody trades like that. Trade increasingly is in different kinds of the same product, so-called intra-industry trade. That includes not just "industry" trade, but services as well.

We import and export services that are similar because different tastes on the part of U.S. consumers and business, there are things that they can purchase from abroad that are not exactly substitutes for things that you can buy in the United States. So cross border trade in similar types of goods and services. So that's well known. That's been documented for years.

But increasingly important in terms of the dynamics of imports and exports is that U.S. producers have decomposed the production process, broken up the production process and situated different components of that production process in different localities, not just around the United States, but also localities around the world.

That has been very effective in improving the price and quality and innovative capacity of U.S. business. U.S.

consumers, as well as business, benefit from those lower prices, the higher quality, and the innovation capacity that is a consequence of this ability of U.S. producers to take the value chain, take what it is that they produce, break it up into these pieces, locate where it's best to produce, for whatever reason they break up the production and put it in different locations. That has been a very important ingredient in the sustained U.S. economic expansion.

It has been important because it's been a key component of keeping inflation low. This breaking up of the value chain is, I believe, a key component in the low prices of information technology products, which are the driver of the domestic investment, and the maintaining of the U.S. economic expansion. This investment strategy and the importance of investment for the U.S. economy right now, of course has increased the capacity of the U.S. economy to grow without inflation, which has allowed the Federal Reserve to leave interest rates at a lower level than they would have -- much lower than anybody would have thought that they would have been, say three years ago.

Federal Reserve Chairman Alan Greenspan now talks about a speed limit -- he never talks about a speed limit, but other people interpret his comments of a speed limit as being three percent. What was it three years ago, it was two-and-a quarter percent. So the institutional response or the ability of U.S. producers to decompose their production structure, to take a part, to globalize themselves, is a critical ingredient in the way that the U.S. economy operates right now in a cyclical sense, but also in the long-term, in terms of its capacity to grow.

Other economies are much slower in understanding this point. Their domestic regulatory structure -- the disadvantages of that is being revealed I believe.

CHAIRMAN WEIDENBAUM: Commissioner Thurow.

COMMISSIONER THUROW: I find this kind of interesting because if we had been here five years ago and said what caused the trade deficit, and I could get the quotes of people who said it, everybody would have said the Federal Government deficit. We had countries like Japan tell us that if we just closed the Federal Government deficit, the American trade deficit would disappear. They all took the same economics courses that everybody in this room took. Of course they were 100 percent wrong.

I think it is a good illustration of misusing that basic identity, because of course what people are saying today is if we just got the household savings rate higher, that would cure the trade deficit. Of course it wouldn’t at all necessarily, because other things adjust. Corporate savings might go down. The Federal Government savings might go down. There isn’t any -- these aren’t causal equations where you can say if I change A in the lefthand side of this identity, B changes on the righthand side. I think it is very important that we all understand that.

I think the other thing that’s kind of interesting here as I listen to this, is I’m probably one of the few people around this room who both took a graduate course in international trade and teach one every spring still. We teach something very different than what we used to teach, when I learned.

When I took international trade, we said that the trade flows dominated and the capital flows adjusted. Now we tend to teach the other way around, that capital flows dominate and the trade flows adjust. We also have a very different concept of the word "long-term," Charlie. I remember when I was taking international trade when people talked about -- let’s say the Japanese had trade restrictions. The idea was that can help them in the short run, but in the long run, the value of the currency will change and it will wipe it out, and it won’t do them any good. My professors were clearly telling me that would happen in a year or two.

The problem now is we have had 20 to 25 years and that hasn't happened. So what the long-run means is a very different thing than what the long-run did before. I think the key thing, Charlie, is what you talked about, is the distributional effects. Because see, I think we get a lot of equanimity here as opposed to a lot of concern in the public because if you take 1998, for example, because of the Asian crisis and the surge in steel exports from Asia, somewhere between 25 and 30 percent of the steel workers in America were laid off. Now if the Asian crisis had laid off between 25 and 33 percent of the American economists, I don't think there would be the equanimity in the economics profession that there in fact is in the economics profession.

But let me ask a question. Charlie, you said something, and I'm not sure I exactly agree with it. I have a question about the other panelists. There is a way that the rest of the world can force the American savings and investment rate into balance. Simply quit sending capital to America. Very quickly, probably via recession, savings would equal investment in America and we would have no deficit.

You made the bold statement that you didn't think that the capital flows into the United States could suddenly stop.

I guess my question to you is why do you think it can't suddenly stop since it suddenly stops everywhere else in the world.

Then a question to the other panelists is what do they think on the possibility of a sudden stop on these capital flows, because it seems to me that that is the real danger. That at some point, we'll have capital flight from the United States in exactly the same sense Korea had it, Mexico had it. I think here again, if I may go back to what I was taught as a Harvard graduate student, nobody can run a trade deficit forever. At some point, you do get capital flight. If you are a very wealthy country, it may take a hell of a long time and a huge net indebtedness, but at some point, that's a danger for everybody.

So I guess my question to you, Charlie, is why are you so confident that can't happen. Then do the rest of you agree?

MR. SCHULTZE: Well, I am not confident you can't get capital flight in the sense of foreign investors being less willing to invest here because their portfolio as dollar assets may have grown to the point they don't want a lot more. In turn, this will force the dollar down, and will force all sorts of changes.

What I mean is that the United States is not a

Korea or a Thailand or an Indonesia which has huge short-term net capital obligations abroad denominated in foreign currency. Our short-term assets and liabilities are both huge, but they almost balance.

You know, if I thought the United States were in the position that many -- Mexico at times, Thailand, Indonesia and others with respect to the net obligations abroad, the banking system, net, mind you, I would be worried to.

COMMISSIONER THUROW: A subsidiary question. If I buy equity shares in the New York Stock Exchange, that's a short-term investment. I would get out in minutes. So it's unfair to simply say I need to look at the formal bank debt borrowing to determine what is the short-run liquidity problem in the United States. Certainly any portfolio investment can be quickly liquidated.

MR. SCHULTZE: Yes, it could be by domestic. It could be done by American consumers as well as foreigners to some extent. Yes, if you have got a stock market crash, that would raise problems. But that is not going to come about because of portfolio effects.

If the U.S. had a really bad stock market crash, I forget what proportion of stocks are owned abroad, but it's still a relatively modest compared to our own. We would have some problems, but the problems would be 85 percent in terms of what domestic.

COMMISSIONER THUROW: Yes, but Charlie, it isn't the amount of money --

MR. SCHULTZE: Foreigners are not -- if the U.S. stock market isn't being deserted by its own --

COMMISSIONER THUROW: But what creates the problem is not even foreigners taking money out of America. If they just quit putting money into America, we have instantly got a crisis.

MR. SCHULTZE: The same thing is true of the stock market in terms of domestic flows. It makes us very vulnerable, but the foreign component of this is relatively modest.

COMMISSIONER THUROW: Do the other panelists agree, that we couldn't have a short-run crisis? I mean the rest of the world is not going to suddenly quit investing. You are confident of that?

MR. SCHULTZE: I didn't hear that.

COMMISSIONER THUROW: Are the other members of the panel also confident that the rest of the world is not going to quickly start on some magic day a la Mexico, stop investing in America?

MR. ROGSTAD: I think there are offsetting short-term accounts here that would prevent that day one blowup, if you will.

I think also it's important to understand how U.S. citizens, businesses and individuals, are now positioned around the world as part of this globalization phenomena. U.S. businesses through direct foreign ownership, are in effect host in-country citizens. As such, they can maintain production levels and control over their operating and financial activities, all of which would be an offset to the kinds of pure flight capital, you are suggesting.

I want to return to the question that was asked earlier about what does competition do to all of this. The globalization phenomenon is here to stay. One of the things that I find when I look at the American business community under these conditions is that there is a discipline involved here that is enormous. No American business can unilaterally raise prices today unless he's got a commensurate quality increase.

So, I think these competitive forces and market signals are getting communicated immediately. There are adjusting mechanisms that I think globalization makes more effective than they have been in the past. This process also serves to prevent that kind of scenario.

CHAIRMAN WEIDENBAUM: Dr. Mann?

MS. MANN: A couple of ways to think about this. The first one is that I agree with Charlie that we are not Korea, we are not Indonesia. We don't even come close. First, our obligations are principally in dollars. Their obligations were principally in foreign currency. The crisis that they face was much more of a foreign currency crisis than one that was based entirely on the out-flow of their own capital.

The second thing is that most of their obligations were short-term, bank-denominated. When a bank says "I'm not going to lend you, and by the way, I want my money back," that is very different in terms of the burden of adjustment as compared to an equity holder who says, "Yes, I'm getting out." But you know what? They bear a large burden of the adjustment through the lower prices.

Now granted that lower prices would also be borne by other holders of those assets, principally U.S. holders of stock market assets. But the burden of adjustment is very much on the holder of the asset and the foreigner who would have to absorb a capital loss on their equity investments.

The third take on this that I think is relevant is to think about the adjustment process that might face the U.S. as compared to any other country when faced with a deteriorated interest on the part of the foreign investors in the U.S. economy. What would happen? Yes, indeed, you would have a depreciation of the exchange value of the dollar. Yes, indeed, you would have a decline, some decline in the U.S. stock market. Yes, indeed, maybe you would have a little bit of difficulty with some banks that were dependent too much on foreign capital.

Where does the U.S. stand with respect to these types of adjustments? Our corporations are very good at adjusting to exchange rate changes. Right now, the stock market has appreciated so much in value that a lot of people are -- it could fall by 25 percent, and people, most people would still have a very large increased value of their wealth. U.S. banks are not nearly as exposed as they might have been say in the 1980s to foreign obligations.

So internal to the U.S. economy, the adjustment process, our ability, our consumers and businesses ability to adjust to the process of adjustment is much better than any of those countries, Mexico et cetera. As an example, I might observe that the United Kingdom, and Italy, and France, all three had very, very severe crises around the time of the breakdown of the

European monetary system. Yes, there was a crisis there, a foreign exchange rate crisis for those countries. None of them collapsed because internal to their markets was the ability to adjust to the economic forces of the crises.

The last point I would like to make is just where are the investors going to go if they don't go to the United States? Some of them might go to Europe, some of them might go to Japan, some of them might go to Asia, some of them might go to Latin America, but probably not very soon. Because Japan is not out of the dumps. Growth in Europe is being viewed as robust, at what, two-and-a-half percent maybe. Latin America is not looking too good right now. So there has to be some place for them to go to to precipitate any problem in the U.S. right now.

So that, I think, is part of the thought process that you have to go through in order to get to the scenario that you are thinking about.

CHAIRMAN WEIDENBAUM: Professor Kregel?

MR. KREGEL: Okay. I am pleased that Dr. Mann has given this last justification for the impossibility of a sharp financial crash, because if you think of last August, we had precisely this case. The question is, where else would people go? The answer was, they had no place to go except to the U.S.

What happened? The United States very nearly had a financial breakdown because people did have someplace else to go. That was to go to cash. A very sharp increase in liquidity premia can bring about changes in interest rates which can put our domestic banking system in difficulty instantaneously. If you look at the balance sheets of the United States' both commercial and investment banks, approximately one-third of their net revenues are generated by what is called proprietary trading. Most of proprietary trading is based on interest rate differential relative value trading.

A very sharp change in liquidity preferences and liquidity premia can change the value of the instruments that banks hold to such an extent that they can be placed in extreme difficulty. This is presumably why the Federal Reserve acted last autumn, as a result of the Russian crisis, in order to prevent a breakdown in the United States financial system, which was not due to the fact of foreign investors leaving the United States, that is, they did not have any other place to go. But they did have some other place to go. They had 30-year Treasury bills to go to. They went to 30-year Treasury bills to such an extent, that they placed the United States financial system in jeopardy.

So I would suggest that yes, there is a possibility of a crisis, but it would not be simply as a result of foreigners leaving, but of foreigners deciding as a result of changes in the U.S. trade balance, to move their investments away from relatively risky investments to less risky investments. This would produce exactly the same effect.

CHAIRMAN WEIDENBAUM: Thank you. The clock is about to run out. Let me ask each of the panelists, would you sum up in one minute or less, your answer to the basic question posed to this panel. What are the causes, what are the key causes, fundamental causes of the U.S. trade deficit?

Dr. Schultze?

MR. SCHULTZE: Looked at over a two or three or four year period, it's what I started with. It's the saving and investment habits and propensities of the American economy. Looked at in the very short-run of the last six months or year or year-and-a-half, it's importantly been the fact that the U.S. continues to grow very rapidly, and the rest of the world on average is growing much more sluggishly, and that has a major impact on our trade deficit. I'm sure there are features that I don't know.

CHAIRMAN WEIDENBAUM: Thank you.

Dr. Rogstad?

MR. ROGSTAD: I might put a little more emphasis on the long-term relative growth performance of our economy vis a vis our trading partners in terms of explaining the behavior of our trade deficit over the last two decades. All of our discussions today have reflected the fact that the question of our reliance on foreign saving to overcome the low saving behavior of the American economy contributes to our ongoing trade deficit. I think this saving issue will continue to be very important in explaining the future outlook of U.S. trade balances.

CHAIRMAN WEIDENBAUM: Thank you.

Dr. Mann?

MS. MANN: Cyclical spending is robust. The rest of the world is growing slowly. That is why the current account deficit has continued to widen most recently.

In addition, capital markets have played an important role because of the attractiveness of the United States as a location for financial investment. That has tended to lead to a stronger dollar.

In comparison to the 1980s, the pattern of spending in the 1990s is better balanced between consumption and investment goods so that the cyclical widening is not so critical today. So for the time being, we're an oasis of prosperity. However, the underlying persistent rise in the trade balance and its association with the persistent deterioration in personal savings, these are trends that cannot continue. They will sow the seeds of change to either or both the exchange rate and U.S. income.

So from a long-term perspective, we are living beyond our means.

CHAIRMAN WEIDENBAUM: Dr. Kregel?

MR. KREGEL: The short-term change in the trade balance has been the inevitable response to the Asian crisis. It has been a suitable response to the Asian crisis.

On the other hand, the longer-term environment suggests that the rest of the world is living far below their means, and they should be encouraged to live up to their means to allow the United States economy to grow at its productive potential.

CHAIRMAN WEIDENBAUM: I thank you all very much, both for your written and for your oral contributions. We stand recessed until 2:30. Thank you all.

(Whereupon, the foregoing matter went off the record at 11:58 a.m. and went back on the record at 2:28 p.m.)